

# Legal Update

## SEC Significantly Narrows Exemption from FINRA Membership for Proprietary Trading Firms

On August 23, 2023, the U.S. Securities and Exchange Commission (“SEC”) adopted amendments (the “Amendments”)<sup>1</sup> to Rule 15b9-1 (“Rule 15b9-1”) under the Securities Exchange Act of 1934 (the “Exchange Act”) that generally eliminate the exemption from the requirement to become a member of a national securities association (an “Association”) – effectively, the Financial Industry Regulatory Authority, Inc. (“FINRA”) – for SEC-registered broker-dealers that engage in proprietary trading of securities off the national securities exchanges (“Exchanges”) of which they are members.<sup>2</sup> As a result, proprietary trading firms that can no longer rely on Rule 15b9-1 must either become members of FINRA or limit their trading activities to the Exchanges of which they are members. The Amendments become effective 60 days after publication in the Federal Register, and the compliance date is one year after publication in the Federal Register.

The SEC estimates that, as of April 2023, there were 64 firms that were SEC-registered broker-dealers and Exchange members but not FINRA members.<sup>3</sup> However, the Amendments may also affect proprietary trading firms that are currently not SEC-registered dealers but could be required to register as such if the SEC moves ahead with its March 2022 proposal to expand the definition of “dealer” under Section 3(a)(5) of the Exchange Act.<sup>4</sup>

### Background

Section 15(b)(8) of the Exchange Act prohibits a registered broker-dealer from effecting transactions in securities unless it is a member of an Association or effects transactions in securities solely on an Exchange of which it is a member. Prior to the Amendments, Rule 15b9-1 set forth an exemption from the Association membership requirement for a registered broker-dealer that: (a) is a member of an Exchange; (b) carries no customer accounts; and (c) has annual gross income derived from purchases and sales of securities otherwise than on an Exchange of which it is a member in an amount no greater than \$1,000 (the “*De Minimis* Allowance”). However, the *De Minimis* Allowance did not apply to income derived from transactions for such broker-dealer’s own account with or through another registered broker-dealer (the “Proprietary Trading Exclusion”). That is, broker-dealers could engage in unlimited proprietary trading of securities on any Exchanges of which they are not members or off-exchange venues (collectively, “off-member-exchange”) without joining an Association, so

long as such activity was conducted with or through another registered broker-dealer.

## Amended Rule 15b9-1

The Amendments rescind the *De Minimis* Allowance and Proprietary Trading Exclusion so that, subject to two narrow exemptions, registered broker-dealers that effect off-member-exchange securities transactions must comply with Section 15(b)(8) of the Exchange Act by joining an Association (FINRA).

Specifically, as amended, Rule 15b9-1 allows an exemption from Association membership for a registered broker-dealer that: (a) is an Exchange member; (b) carries no customer accounts; and (c) effects securities transactions solely on an Exchange of which it is a member, except that:

- (1) The broker-dealer may effect off-member-exchange securities transactions that result solely from orders that are routed by an Exchange of which it is a member in order to comply with Rule 611 of Regulation NMS<sup>5</sup> or the Options Order Protection and Locked/Crossed Market Plan<sup>6</sup> (the "Routing Exemption").

Importantly, to rely on the Routing Exemption, broker-dealers must use the Exchange's designated routing broker-dealer. Alternatively, a firm wishing to route orders to Exchanges using a non-exchange-designated routing broker-dealer could comply with Section 15(b)(8) of the Exchange Act by becoming a member of all exchanges to which it routes orders. However, any such firm would be required to join FINRA to the extent it effects off-exchange securities transactions (unless exempted by the stock-option order exemption).

- (2) The broker-dealer may effect off-member-exchange securities transactions, with or through another registered broker-dealer, that are solely for the purpose of executing the stock leg of a stock-option order (the "Stock-Option Order Exemption").<sup>7</sup>

A broker-dealer seeking to rely on the Stock-Option Order Exemption must establish, maintain and enforce written policies and procedures reasonably designed to ensure and demonstrate that such transactions are solely for the purpose of executing the stock leg of a stock-option order. The broker-dealer must also preserve a copy of its policies and procedures in a manner consistent with Rule 17a-4 under the Exchange Act until three years after the date the policies and procedures are replaced with updated policies and procedures.

## Considerations Relating to FINRA New Member Applications and Regulatory Fees

Firms that are required to become FINRA members as a result of the Amendments will be required to apply for membership with FINRA and become subject to the fees charged by FINRA to its member firms, including certain regulatory fees designed to recover the costs to FINRA of the supervision and regulation of its members. This includes a Trading Activity Fee ("TAF") that FINRA assesses each member on the sale of certain covered securities (including all exchange-listed securities wherever executed and all other equity securities traded otherwise than on an Exchange). In this connection, in June 2023, FINRA amended the TAF such that it will not

apply to transactions by a proprietary trading firm effected on an Exchange of which it is a member.<sup>8</sup>

While FINRA generally has 180 days to issue a decision after the filing of a new membership application and may issue a “fast-track” decision within 100 days, it intends to implement an expedited membership application process for proprietary trading firms and anticipates processing these applications within 60 days after submission.

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## Endnotes

- <sup>1</sup> See [Exemption for Certain Exchange Members](#), Exchange Act Release No. 98202 (Aug. 23, 2023). The SEC previously proposed amendments to Rule 15b9-1 in 2015, and re-proposed the amendments, with certain modifications, in 2022. See Exchange Act Release No. 74581 (Mar. 25, 2015), 80 FR 18036 (Apr. 2, 2015) and Exchange Act Release No. 95388 (Jul. 29, 2022), 87 FR 49930 (Aug. 12, 2022).
- <sup>2</sup> As the only Association currently, FINRA is the self-regulatory organization (“SRO”) primarily responsible for exercising SRO oversight over broker-dealers’ securities trading in the over-the-counter (“OTC”) or “off-exchange” market, which includes securities transactions that occur through alternative trading systems (“ATSs”) or with another broker-dealer that is not registered as an ATS (*i.e.*, OTC market makers). The National Futures Association (“NFA”) is also registered as a national securities association (as specified in Section 15A(k) of the Exchange Act), but only for the limited purpose of regulating the activities of NFA members that are registered as a broker-dealer in security futures products pursuant to Section 15(b)(11) of the Exchange Act.
- <sup>3</sup> Specifically, of these 64 firms, 22 were members of a single Exchange; nine were members of two Exchanges; 15 were members of more than two but ten or fewer Exchanges; and 18 were members of more than 10 Exchanges.
- <sup>4</sup> See Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer, Exchange Act Release No. 94524 (Mar. 28, 2022), 87 FR 23054 (Apr. 18, 2022) (the “Dealer Proposal”). Please also see our Legal Update, [SEC Rule Proposal Seeks to Clarify “Dealer” Definition for Persons Engaging in Liquidity-Providing Activities](#) (Apr. 20, 2022). According to the SEC’s Spring 2023 regulatory agenda, a final rule on this proposal is slated for adoption in Fall 2023. See Office of Management and Budget, Office of Information and Regulatory Affairs, [Agency Rule List – Spring 2023: Securities and Exchange Commission](#).
- <sup>5</sup> Rule 611 of Regulation NMS requires trading centers, such as Exchanges, to establish, maintain and enforce written policies and procedures reasonably designed to prevent “trade-throughs” (*i.e.*, the execution of an order at a price that is inferior to the price of a protected quotation displayed by another trading center) in exchange-listed stocks, subject to certain exceptions. To facilitate compliance with Rule 611, Exchanges have developed the capability to route orders through broker-dealers (many of which are affiliated with the Exchanges) to other trading centers with protected quotations.
- <sup>6</sup> See Exchange Act Release No. 60405 (Jul. 30, 2009), 74 FR 39362 (Aug. 6, 2009) (the “Options Linkage Plan”). In the options market, the Options Linkage Plan is a national market system plan that requires linkages between the options Exchanges to protect the best-priced displayed quotes in the market and to avoid locked and crossed markets. It also requires each participating Exchange to establish, maintain and enforce written policies and procedures reasonably designed to prevent trade-throughs and address locked and crossed markets in eligible options classes.

- <sup>7</sup> For purposes of relying on the Stock-Option Order Exemption, a broker-dealer is required to adhere to the definition of the term “stock-option order” set forth in the rules of the Exchange where the stock-option order is handled and of which the broker-dealer is a member.
- <sup>8</sup> See FINRA, Notice of Filing and Immediate Effectiveness of a Proposed Rule Change To Amend FINRA’s Trading Activity Fee, 88 FR 42404 (Jun. 30, 2023). FINRA will implement the TAF amendment 60 days after the Amendments have been published in the Federal Register, and will announce such implementation date in a Regulatory Notice.